

# Foreign aid transaction costs

Citation for published version (APA):

Vandeninden, F. (2012). *Foreign aid transaction costs*. UNU-MERIT, Maastricht Economic and Social Research and Training Centre on Innovation and Technology. UNU-MERIT Working Papers No. 007

**Document status and date:**

Published: 01/01/2012

**Document Version:**

Publisher's PDF, also known as Version of record

**Please check the document version of this publication:**

- A submitted manuscript is the version of the article upon submission and before peer-review. There can be important differences between the submitted version and the official published version of record. People interested in the research are advised to contact the author for the final version of the publication, or visit the DOI to the publisher's website.
- The final author version and the galley proof are versions of the publication after peer review.
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## UNU-MERIT Working Paper Series

**#2012-007**

### **Foreign aid transaction costs**

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**UNU-MERIT Working Papers**

**ISSN 1871-9872**

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# Foreign Aid Transaction Costs

Frieda Vandeninden<sup>\*</sup>

## Abstract

The term ‘transaction cost’ has been widely mentioned in the recent literature on aid effectiveness. In fact, the shift into the aid delivery system (see e.g. the Paris Declaration on aid effectiveness) has been justified among others by the high transaction costs generated by the previous aid modalities. In this paper, we first want to understand what the notion of transaction costs means in the context of aid delivery and give a typology of the possible costs. We also develop an analytical framework to evaluate them. This framework appears to be a relevant tool to compare the effectiveness of aid modalities. We finally apply this analytical framework in Mali: we look at the evolution of the foreign aid transaction costs in two sectors (health and education) with the introduction of sector-wide programmes.

Key words: aid modalities, aid effectiveness, transaction costs

JEL Codes: O20, O22, D23

## 1. Introduction

The question of aid effectiveness has led to an important debate over the past 20 years. There exists a wide empirical literature about the impact of aid on poverty reduction and growth.<sup>1</sup> However, there are still no clear-cut conclusions about the relative ineffectiveness of aid. Although most of the scholars agree that aid has a weak impact on development, the explanation of this ineffectiveness has found no consensus. For a long time, many economists claimed that the major causes of the ineffectiveness were the poor institutional capacities and the bad policy environment (see e.g. Burnside and Dollar 2000).

However, as this hypothesis is a bit too deterministic (because it would imply that aid should be given only to recipient with good policies for instance), the International Community and some development economists have also questioned the aid modalities. In fact, the way aid is delivered could not fit a country’s specific policies and economics environment and this could also explain the poor effectiveness. The ‘previous’ delivery

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<sup>1</sup> See for instance Burnside and Dollar, 2000 and Easterly et al., 2007.

system, represented mainly by project aid, has thus been more and more criticized. The main critiques are the following:

- Lack of coherence between donors policies, but also between donors and recipients,
- Fragmentation and duplication of developmental projects,
- The lack of ownership and leadership of the partner countries: the development projects are often decided by each donor, without any consultation of the recipient,
- The donors do not use the national procedures to give aid: there is thus no capacity building.

All these critiques underline problems that have lead to a deep questioning of the aid delivery system. In fact, the aid agencies realized recipients bear a high 'costs' due to their different requirements and approaches to deliver the aid. Moreover, because of the relative independence of each donor, there is a duplication of efforts. They consequently also bear a 'cost'. This notion of 'cost' or 'transaction cost' is imprecise, but it is clear that the characteristics of the previous system lead to some 'losses' on both partners.

In early 2000, the International Community agreed that changes would be needed (see High-Level Forums on aid effectiveness). The following statement, made by Ministers, Heads of Aid Agencies and other Senior Officials of 28 aid recipient countries and more than 40 multilateral and bilateral development expresses this awareness: *'We in the donor community have been concerned with the growing evidence that, over time, the totality and wide variety of donor requirements and processes for preparing, delivering, and monitoring development assistance are generating unproductive transaction costs for, and drawing down the limited capacity of, partner countries. We are also aware of partner country concerns that donors' practices do not always fit well with national development priorities and systems, including their budget, programme, and project planning cycles and public expenditure and financial management systems. We recognise that these issues require urgent, coordinated, and sustained action to improve our effectiveness on the ground'* (Rome Declaration on Harmonisation in February, 2003).

The donors consequently agreed upon some new guidelines that are formalized in the Paris Declaration on Aid Effectiveness (2005). The commitment on the donors to the new guidelines has also been confirmed in 2008 (see the Accra Agenda for Action). The main ideas are:

- The ownership by the partner countries,
- The alignment of donors on recipients' strategies and procedures,

- The harmonization between donors' actions,
- A mutual accountability,
- A managing for results.

These new ideas represent an important shift into aid delivery system: the new system, also called the programme approach, should outweigh the inefficiencies of the project approach. And consequently, the transaction costs are expected to decrease. Let us note that in practice, the programme approach can take the form of a sector programme: the donors and the recipient decide together on the allocation of aid to a particular sector (e.g. health, education). The Poverty Reduction Strategy Papers are another example. According to the International Community, this new aid system should enhance the aid effectiveness by decreasing the transactions costs. It seems that the link between aid effectiveness and foreign aid transaction costs is quite obvious: to enhance the effectiveness, the transaction costs have to decrease. However, this notion of transaction cost is rather confuse in the aid literature. And even if scholars, aid practitioners often refer to reduction of the transaction costs as an important challenge of the programme approach, they do not formally explain what these costs are.

Consequently, in this paper, we first want to understand the concept of transaction cost (part 2). We thus refer to the Transaction Cost Economics (TCE) to define formally the transactions costs in the case of foreign aid. Then, we develop a conceptual framework to compare and evaluate the effectiveness of the aid modalities. This framework consists in a typology and an evaluation of the foreign aid transaction costs. We indeed want to verify whether the new aid delivery system decreases the transaction costs<sup>2</sup>. Analysing the aid modalities with the transaction costs economics should, to a certain extent, allow us to identify which modality minimizes these transactions costs. It will thus help us to measure the effectiveness of foreign aid.

The third part of this work is devoted to a case study: the sector approach in Mali. We apply our typology to analyse the evolution of the transaction costs since the introduction of two sector-wide programmes: the PRODEC ('Programme Décennal de Développement de l'Education') and the PRODESS ('Programme Décennal de Développement Sanitaire et

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<sup>2</sup> This hypothesis hasn't been empirically verified. See Killick T., 2004, p. 19 : « The superiority of program aid [...] rests on a presumption of the comparative costs of the respective aid modalities, which has not, so far is known, been empirically established in any systematic way. »

Social’). The question is to see whether the transaction costs have decreased with this programme approach.

We show that the costs do not seem to decrease globally, mainly because of the political, technical and institutional constraints.

## 2. The transaction costs: definition and typology

To understand what the transaction costs are in the context of the transaction of foreign aid, we refer to the Transactions Costs Economics. Indeed, aid delivery is a transaction: the donors transfer some money to a partner country and expect, in exchange, some results (e.g. poverty reduction, vaccination campaign, etc.). The TCE is thus a relevant tool to help us understand how the costs can be minimized.

In order to develop an analysis framework, we define and give a typology of the possible costs occurring with the aid delivery. This initial stage will allow us to determine the weaknesses and strengths of each aid system delivery and to compare them. But first, let introduce the main concepts of the TCE.

### 2.1. The transaction cost Economics

This economic theory has been mainly developed by O. E. Williamson in the 1970’s and by D. North in the early 1990’s. The theory aims at finding out the best way to organize a transaction of goods or services between two economic agents (Williamson O. E., 1993, p.16). The principle is that the structure of governance chosen for the transaction has to minimize the transaction costs, taking into account that each transaction differs according to its qualities – frequency, uncertainty, and asset specificity. The TCE also relies on two main hypotheses. These hypotheses explain why the transaction costs occur.

#### a. Behavioural hypotheses

- The first hypothesis is the *bounded rationality*. Economic agents cannot predict precisely how the transaction will evolve. It implies that every contract is per se incomplete.

- The second one is the risk of *opportunism*. Because of the contract incompleteness, there is a risk that the agents involved in the transaction take profit of the imperfect distribution of information.

As a consequence of these hypotheses, when a transaction takes place, the agents involved bear high costs in order to cope with the contract incompleteness and the risk of opportunism. In the context of developing countries, these hypotheses may be interpreted in terms of corruption, irrational behaviours (different ministries could accept overlapping projects for instance) and difficulty to ensure the link between donors and recipients (unnecessary monitoring procedures, conditionality, etc.).

#### **b. Transactions characteristics**

In order to choose the right structure of governance, we also have to look at the characteristics of the transaction. In fact, we have seen that because of the behavioural hypothesis, the agents bear some costs in order to protect themselves from the opportunism and the contract incompleteness. And depending on the characteristics of each transaction, some structures of governance will be preferred. In the TCE, there are three types of characteristics.

- *Asset specificity*. If the transaction has a high level of asset specificity, the transaction concerns non-standard goods that require specific investments that cannot be easily re-used for other transaction. For example, producing a specific good can require the construction of a machine that will only produce this good. If the transaction ends, that is if the good is not produced anymore, the investment will be lost. The impact on the choice of transactions governance is clear: when asset specificity is high, both parts want that the transaction goes to termination; if it does not, the investments in specific asset will be lost or devaluated. In the context of aid transfer, the investments in specific assets are generally high. On one hand, the recipient government has to make some investments to manage the aid transfer (investments in civil servants formation among other). On the other hand, the donor government devotes some resources in order to ensure itself that the transaction goes well (sending technical assistants, monitoring procedure, etc.).
- *Uncertainty*. As the information is always incomplete, the agents cannot predict the performance of the other agent. This incompleteness of information can take the form of moral hazard (one agent cannot assess other agent's effort) or asymmetry (one



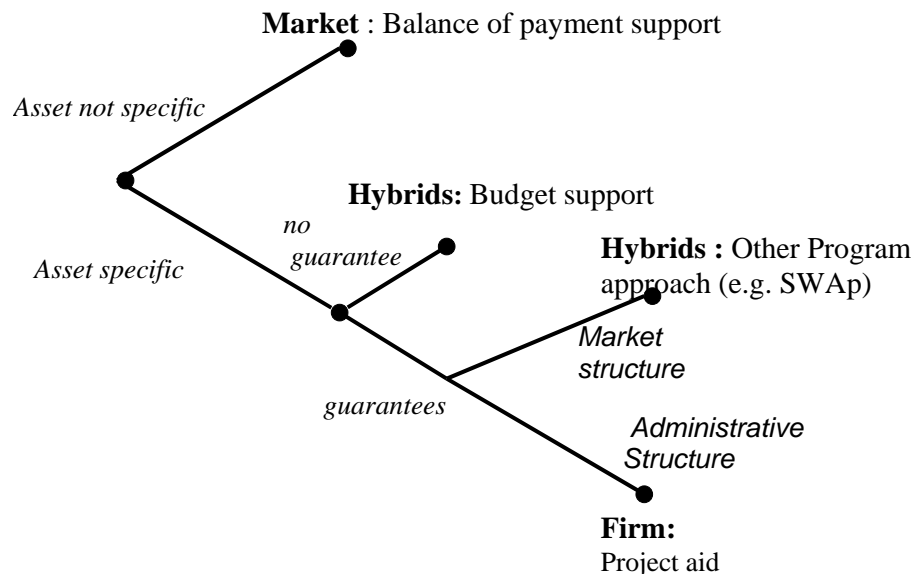
agent has more information than the other).<sup>3</sup> This lack of transparency makes that the principal (the International Community) does not always know how the agent (the recipient) allocates the aid. Of course, this uncertainty increases the control costs.

- *Frequency*. This point is quite obvious. The more frequently the transaction takes place, the more easily the costs are recovered. Both agents will profit from economy of scale.

### c. Structures of governance

Having these two behavioural hypotheses and the three characteristics in mind, we can link them and find the structures of governance minimizing the costs.

**Figure 1:** Foreign aid modalities and governance structures



Source: adaptation of Williamson (1994, p.52)

Let us take a look at this graph. The transactions taking place on the market concern generally non-specific goods. These standard products can be realized easily by a lot of agents. It gives to both parts of the transaction a sufficient protection against opportunism (the provider can be replaced if he does not respect his engagements). And it is not necessary to build an accurate contract that foresees the transaction evolution.

<sup>3</sup> We here refer to the principal-agent theory.

The opposite structure of governance is the firm. When goods have a very high level of asset specificity, both parts of the transaction have to protect themselves against the risk of transaction cancellation (this cancellation would imply important “sunk costs” (Williamson, 1993, p. 16)). And if the uncertainty and or the frequency are very high, it can be preferable to internalize the transaction in one economic unit, the firm. But inevitably, this structure of governance is very costly to set up and leads to new costs (e.g. management costs).

The structures of governance called hybrids present both characteristics of the market and the firm. In practice, they take the form of all types of contracts. The products involved here have a higher level of asset specificity and require thus a contract stipulating the transaction expectations (nature of the good, quality, shipping details, etc.). However, the characteristics are not such that the firm is better. In fact, for instance, when the frequency is not very high, then the costs induced by the internalization of the transaction in a firm are not recover easily. It is thus better to set up a contract, still facing some costs, but not bearing the new costs induced by the firm (management costs).

Applied to the aid transfer context, this graph can be interpreted as follows. Aid transfers that are not associated with specific requirements as for the use of funds, and therefore do not entail specific management tools (conditionality, reform measures, indicators, monitoring processes, etc.) can easily be managed through a market-like governance structure; this situation can be assimilated with the *balance of payment support*. However, donors – and governments – often attach a value as to how aid funds are used, and are ready to invest in further specific assets (conditionality, experts, monitoring systems, etc.) to prevent aid from being misallocated by opportunism. According to transaction cost economics, such asset specificity associated to aid entails that non-market governance structure are optimal to minimise transaction costs. Following our analytical framework outlined in Figure 1, three cases may be encountered. When donors do not specify how aid funds should be allocated (so that the recipient government decides on how to use them) and therefore do not set up specific “guarantees” system, a hybrid contract appears to minimise aid transaction costs. When applied to our purpose, this situation can be assimilated with *budget support*. When donors stipulate how the money should be allocated and frequently interact with the government on related matters, the corresponding hybrid structure of governance appears to be *programme approaches* in general, especially the sector-wide approach (SWAp). Finally, when donors have such precise requirements regarding the use of

aid funds that they prefer to manage them by themselves, they can set up a firm-like hierarchical structure in order to control the transaction, under the form of a *project*.

The fundamental question addressed in this paper is which modalities minimize the transaction costs. But the answer does not seem straightforward. In fact, it depends on the different characteristics of the aid transfer, and these latter depend on the specific countries context. Even if in theory, we agree that a programme approach will allow division of labour and coordination between donors, harmonization of procedures, less duplication of developmental efforts, it is not proved formally that the transaction costs will decrease. Moreover, we also have to take into account that some new types of costs could emerge with a new aid delivery system (e.g. costs of harmonization). To try to answer our question, we should thus proceed by case study (see section C for Mali) and review the evolution of each costs. The next section thus aims at defining and identifying the foreign aid transaction costs.

## **2.2. Foreign aid transaction costs**

We have seen that each transaction generates some costs. The transaction ‘aid transfer’ also does. We first want to identify these costs and then compare the different organizational structures. According to the European Commission, the new aid approach (or programme approach, based on partnership) should lead to a decrease of the transaction costs (European Commission, 2003, p. 14). The conceptual framework we build in the subsequent section aims at verifying this hypothesis. More generally, it also allows evaluating and comparing the effectiveness of aid delivery systems. We provide an analytical framework to empirically test the effectiveness of aid modalities.<sup>4</sup> In fact, ‘the superiority of programme aid in this respect remains only a hypothesis because it rests on a presumption of the comparative costs of the respective aid modalities, which has not, so far as is known, been empirically established in any systematic way’ (Killick, T., 2004, p.19).

We define the transaction costs of foreign aid as *all the costs implied by the aid management*. According to the European Community, these costs include all the expenditure necessary to the transfer of foreign aid. These expenditures have no value for the donor and

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<sup>4</sup> The framework developed in this section is the author point of view. We refer to the TCE and keep the logic of this theory. However, we propose our own typology and indicators, which are specific to the case of aid transfer.

for the recipient. They only occur to make the aid transfer possible (European Commission, 2003, p. 14).

Before giving a typology of these costs, we would make some preliminary remarks. The definition given by the T.C.E. does not totally satisfy us. It misses the fact that these costs are not always 'lost' in the transaction. Some can generate value added. They can be induced by activities with positive externalities (for example, coordination meetings improve the relations between both parts, etc.). We will thus distinguish 'pure' transaction costs from 'investment in harmonization' costs. Moreover, it is not useless to mention that all the costs are not financial. Most of the transaction costs are opportunity costs and have to be interpreted in terms of loss of time, bad exploitation of human resources, etc.

We can now expose the typology of the costs, based on the following criteria. For a case study, we have to look at these criteria to understand the problem. This will allow us to evaluate the costs, and as a consequence, to identify the most appropriate structure of governance, or aid modality.

#### **Classification criteria:**

- *Timing of the costs.* They can be shared in three periods: ex ante, ex post, but also during the transaction. In fact, 'transaction costs occur at all stages of the aid management cycle, from the initial negotiation of aid through to disbursement, implementation (including procurement, construction, etc), and monitoring of the activities it finances' (European Commission, 2007, p.27).
- *Agency costs.* These come from the asymmetry of information. According to the Principal-Agent Theory, a principal (here the donors) delegate a task (the realization of a project or developmental programme) to the agent (the recipient). The recipient has more information (on the institutional context for instance) than the principal. Moreover, the principal cannot observe the agent's effort (non-measurable outputs for instance). These two informational problems, respectively adverse selection and moral hazard, can lead to some costs (additional monitoring procedures, funds distortions, etc.).
- *Investment in harmonization costs.* Some expenditure (e.g. cost of coordination) can have positive effects on the transaction. Indeed, 'transaction costs are not a pure efficiency loss: the same activities that embody transaction costs may also have positive benefits (e.g. learning from working groups, mitigating risks through

fiduciary safeguards)’ (European Commission, 2007, p.27). We therefore have to consider a specific category for this type of costs.

- *Fixed costs vs. variable costs.* The fixed costs occur in the transition between two modalities. Variable costs are the other routine costs. It is important to distinguish them because an evaluation of the transaction costs during the implementation of a sector-wide approach for instance will probably show an increase in the costs, but these are fixed costs and appears only because of the transition between two aid instruments.
- *Opportunity costs.* We want to stress the fact that in the case of the foreign aid transaction, the costs are mainly non-financial. We then take into account all the opportunity costs (loss of time, human resources, etc.).
- *Who bears the costs?* If the recipient bears the majority of the costs, it will evidently impede the aid effectiveness. Besides, when the donors bear high cost, the total aid available is decreased by this burden. It is thus important that both costs decrease.

In what follows, we identify the major transaction costs occurring with the aid disbursement and we assign some indicators to measure each of them (see Annex 1). A quantitative analysis of transaction costs will then be possible within this framework.<sup>5</sup>

### *Ex ante costs*

These costs occur before the aid transfer. We indentify two costs:

- The identification costs: they are related to all the preliminary reports done before the implementation of a project/programme. They can include the evaluation of the cost of the project, an analysis of the objectives, etc.,
- The formulation costs: these are related to the planning of the project/programme.

### *The costs during the transaction*

- The costs of investment: these are beard by the donors and are necessary for the execution of the project/programme (e.g. rent of offices in the partner country),

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<sup>5</sup> Nevertheless, during our research in Mali, we realized some indicators were really difficult to measure and required information hard to get.

- The costs of administration and management (e.g. the remuneration of the director of the project).

### *Ex post costs*

- The costs of follow up,
- The costs of financial control and extern audit,
- The impact evaluation.

### *The agency costs*

- The cost of ownership: they are related to the lack of confidence between the donors and the recipient's institutions (e.g. unnecessary monitoring measures),
- The costs of coherence: they include all the costs related to projects/programmes that are not in the national priorities of the partner country.

### *The investment in harmonization costs*

The implementation of a programme approach lead to some new costs that did not exists with a project approach. We consider these costs as an investment since they will have some positive effect in the long run on the donors-recipient relationship.

- The harmonization costs: these costs occur when the donors work together to harmonize their procedures,
- The coordination costs: they are related to the effort of the donors and the recipients to work together within a same sector or programme.

To assess the effectiveness of the aid modalities, one has to look at all the resources 'wasted' to deliver the aid. Evidently, the aid effectiveness depends strongly on the minimization of these costs. However, we should also stress the fact that some costs, are not pure transaction costs. This is the case of the investment in harmonization costs. These costs have a positive impact on the aid transaction. Therefore, the choice of aid modalities depends on the transaction costs and also the investment in harmonization costs. More precisely, a modality will be preferred to another one when the decrease in transaction costs from modality 1 to modality 2 (a programme approach) is higher than the investment cost induced by the modality 2. In fact, if the saving on the transaction costs is small and the investment costs of a programme approach are high, then the change in aid modality is not worthwhile. In other

words, it is more effective to adopt modality 2 if  $TC_1 - TC_2 > IC_2$ . And in order to measure the transaction costs, we set up a list of indicators for each of them (see appendix 1). This will allow us, to a certain extent, to quantify the transaction costs. Let see in practice, how we can apply this analytical framework.

### **3. APPLICATION: THE CASE OF MALI**

We apply this framework to the case of Mali. The quantitative data to measure the foreign aid transaction costs (see appendix 1) are not easy to collect.<sup>6</sup> We therefore add a qualitative survey in order to bring the most accurate answers to our research question “Does the Sector Programme allow reducing foreign aid transaction costs, compared to Project Aid?”. We sent the survey to the stakeholders of donors’ agency in Mali and to civil servants in charge of the sector wide approach. The questionnaire is divided in two parts. First, there are some general questions about the transaction costs. This allows us to understand better the transaction cost concept and also to realize that this concept was often misused. The second part of the questionnaire aims at evaluating the evolution of the transaction costs since the introduction of sector wide approach.<sup>7</sup> For this last part, we developed two different questionnaires: one for the donors’ stakeholders and one for the partner countries’ stakeholders.<sup>8</sup>

We chose the case of Mali because two sector wide programmes have been implemented in 2000 and 1998 respectively: the PRODEC (‘Programme Décennal de Développement de l’Education’) and the PRODESS (‘Programme Décennal de Développement Sanitaire et Social’). There are both quite representative of the programme approach.

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<sup>6</sup> We stayed only 3 weeks in Mali and get the data only from two donors’ agencies (Belgium and Germany) and some punctual data from the ministry of health and education. We cannot thus quantify entirely the transaction costs for these sectors.

<sup>7</sup> The interviews have been conducted in 2005.

<sup>8</sup> In the qualitative questionnaires, we ask to each stakeholders their opinion about the evolution of each transaction costs. They are available on demand (see author’s contact information).

As claimed by the International Community and many donors, the new aid paradigm should increase aid effectiveness by the reduction of transaction costs. We therefore look at whether these two sector wide programmes reduce foreign aid transaction costs in Mali.

Before answering this question, we should add some remarks about the difficulties to set up a sector wide approach. As said in the previous section, the aid modality that minimizes the transaction costs depends on the transaction's characteristics and then on the specific country context. And in Mali, there are some constraints that hindered the implementation of this aid modality. We identify three types of constraints: political, institutional and technical.

- *Political constraints*, because donors often want their contribution to be visible and identifiable. However, when giving aid by the means of Sector-wide Programmes, the contribution of each donor is not as straightforward as with Project Aid. Moreover, it is not easy to find a consensus among the donors over the developmental strategy for the sector. They also do not always agree on the disbursement procedures.
- *Institutional constraints*: according to many technical and financial partners, there is a huge lack of national human resources, as much in terms of quantity as in terms of quality. The weight of politics on nominations (in ministries) being high, there is a constant roll within the civil servants occupations. That roll prevents nationals from capitalizing the knowledge and the know-how.
- *Technical constraints*, because Sector Approach (especially its implementation) requires a lot of meetings between the donors and the civil servants. Those later have thus less time to achieve management and administration tasks. Let us note that this constraint generates the so-called fixed costs.

This analysis of transaction costs is thus entirely based on our interpretation of the data we collected in Mali. We gather the opinion of about 20 stakeholders in the health and education sectors and some punctual data on the indicators (such as the number of meetings of coordination, number of evaluation report, technical assistants, etc.). We cannot quantify entirely the transaction costs with our survey, but it clearly can give an indication on their evolution. Let us remind that we keep a comparative logic: how does the sector wide approach (S.A.) costs evolve compared to P.A. (project approach) costs? In what follows, we review the evolution of each transaction costs identified in the previous section.

### 3.1. Evolution of each costs



## I. Ex-ante costs evolution

### *Identification costs*

These costs globally decrease for donors, because there is a sector programme defining actions to undertake. Each donor does not have to undertake separated studies to identify cases in which to intervene or macroeconomic survey for instance. On the other part, recipient's stakeholders are more implied in the identification process than with a Project Approach. There are thus new costs that appear on the recipient with the S.A.. However, it seems that the economies of scale on the donors' side compensate this costs increase and the recipient's side so that they globally decrease. In theory, they should keep on decreasing.

### *Formulation costs*

With the S.A. in Mali, each donor still uses a different way of financing so that formulation costs stay important. This is one of the major obstacles of the transaction cost decrease: as donors do not harmonize their financial instruments, the partner country still faces multiple procedures and still bears high transaction costs. Note that we can expect that these costs will decrease with time (for instance, within the PRODEC, the Canada, the Netherlands and the World Bank use the same procedure of disbursement, via a pooling fund). Theoretically, S.A. should reduce the formulation costs when the harmonization will be more effective.

## II. Costs during the process

### *Investment costs*

There is not a real evolution of the investment costs from P.A. to S.A.. In both cases, there is a follow-up from day to day, technical assistants in charge of the programme, etc. According to the donors' stakeholders, they still face the same costs as before. But these costs should decrease when the donors will have more confidence in institutional capacities (see institutional constraint).

### *Administration and management costs*

For the financial partners, these costs do not really evolve, because each donor has its own requirements and the administration and management of the sector wide programme are

similar to the ones of a project. In other term, because there is not a real harmonization between the donors, these costs remain the same. We could just note a small decrease for some donors who use pooling fund (e.g. Canada and Netherlands in education). However, everyone agree that these costs will decrease when the procedures will be harmonized (large decrease for donors because of labour division and small increase for recipient). On the recipient side, the costs of management and administration have increased since the implementation of the programmes requires a strong implication of the recipient's stakeholders (not as in a project approach). And these latter often complain that they face additional and new tasks for the same quantity of staff and financial compensation. Therefore, these costs have globally (for donors and recipient) increased.

### III. Ex-post costs evolution

#### *Follow-up and financial control costs*

With the implementation of a programme approach, these costs should fall. However, we found no evolution so far since each donor uses a different financial control, requires a follow-up and does not use systematically evaluation reports from national authorities (judged often too weak by the donors' stakeholders).

#### *Evaluation costs*

Compared to P.A., the evaluation costs decrease slightly. Normally, there is only one evaluation report for the whole programme. But some donors continue to demand parallel reports in order to determinate their own real impact. This undermines the potential high decrease of those costs.

### IV. Agency costs evolution






#### *Incoherence costs*

The major cost decrease implied by S.A. takes place here. The coherence between actions made in one sector (health or education) is real. The donors do not undertake two identical projects in the same region for instance. There is thus less duplication of efforts.

#### *Delegation costs*

These costs do not exist with P.A. since the government role is quasi inexistent. In a S.A., they are really important, at least for now, because the institutional capacities are not seen as efficient enough. National's civil servants sometimes lack experience, skills and the important turnover in the ministries hinders the capitalization of knowledge. Consequently, donors are not very confident in recipient's institutions and they maintain technical assistants in the ministries and require a close follow-up and numerous evaluation reports. This delegation increases the risk of funds misuse and thus the costs to prevent that misuse. Once the institutional capacities will be judged strong enough, these costs will decrease sharply.

We recapitulate the evolution of the different costs in the following table:

		<b>Evolution from P.A. to S.A.</b>	<b>Comments</b>	<b>S.A. in theory</b>
Ex-ante	Identification		Slight decrease because decrease for donors but new costs for recipients	weak
	Formulation	none	Decrease if political constraint disappears	weak
During the process	Investment	none	Decrease if institutional constraint disappears	weak
	Administration and management		No evolution for donors but increases for recipient	middle (borne mainly by recipient)
Ex-post	Follow-up and financial control	none	Decrease if institutional/political constraint disappear	weak
	Evaluation		Decrease more if political constraint disappears	weak
Agency costs	Incoherence		Major effective reduction	weak
	Delegation to recipient		Decrease if institutional constraint disappears	weak

From this table, we see that the evolution of the transaction costs is quite ambiguous. Two costs increase sharply (new administration costs for the recipient and news cost from the delegation) and only three costs decrease slightly (because of the constraints).

Before trying to advance any conclusions, we should look at the different criteria that we pointed out in the first part of the paper. In fact, since the aid transaction has a high frequency, we have to take into account that fixed costs will be recovered easily and decrease in time. Then, if the increase in transaction costs is only due to the fixed costs, it is still worthwhile to adopt the new aid modality. These costs are indeed occurring once, during the implementation of a new modality. Moreover, it is important to consider that the implementation of a programme approach require some investments (in harmonization and coordination).

## V. Fixed and variable costs evolution

All the costs described above are either fixed or variable. The first ones are due to the P.A.-S.A. transition. The second ones are implied by the aid transfer in general. The fixed costs are initially high, but are going to decrease quickly in time. It is thus important to distinguish them.

We identify two major fixed costs. The identification costs have decreased but only slightly, however, the set up of the programme requires lot of time, meeting (usually more than with a project). Evidently, since it was the first time that sector programmes have been implemented in the education and health sector, we expect that with time these costs will keep on decreasing. The second fixed costs are the management costs. In fact, when adopting new procedures, a period of adaptation is necessary for both donors and recipients. The donors are now implied in the programme administration while the donors still bear the same costs as with a project approach. We can expect that these costs will decrease once everyone get used to this new way of ‘working’ (and also if the donors trust the institutional capacities of the recipients, see institutional constraint). Note that in the long run, these costs are supposed to be beard mainly by the recipient (this reflect the ownership of the programme).

## VI. Investment in harmonization costs

### *Harmonization costs*

These costs do not exist with a P.A., because each donor sets up his own project by himself. With a sector-wide approach, these costs are expected to be high. However, in Mali, the harmonization is not on the agenda. Donors are not yet ready to unify their procedures and

requirements. This, in turn, hinders the decrease of some of the transaction costs mentioned above.

### *Coordination costs*

The major cost difference between P.A. and S.A. resides here. The implementation of a S.A. requires a lot of coordination meetings. These meetings consume many resources (financial, human and in time). Again, these meetings should be less frequent when the donors delegate the management tasks to the nationals' stakeholders (no more institutional constraint).

Let us remain that these costs occur with a programme approach. But they are generated by activities that create positive repercussions in the long run. Let us note some examples. The coordination meetings allow to improve the information and to strengthen the confidence between partners. The recipient leadership allows nationals to capitalize knowledge and know-how. There are important positive externalities that have to be taken into account in the long run.

### 3.2. Evolution of the transaction costs in Mali

We wanted to answer this question: **Does the sector wide approach reduce foreign aid transaction costs, compared to project approach?** More specifically we verified the assumption that **a programme approach reduces foreign aid transaction costs, compared to project approach.**

According to our 2005 survey, the situation in Mali does not verify this hypothesis. In fact, as seen above, the evolution of the transaction costs since the implementation of the sector-wide programmes is not clear: two costs increase while three of them decrease slightly and the others remain constant. Consequently we cannot conclude that the transaction costs have decreased. On the other side, the investment costs have increased but not as expected (because there is no harmonization of the procedures). Thus, two questions remain: What does explain this ambiguous evolution? And, is it worthwhile to implement a programme?

As explained above, the evaluation of the foreign aid transaction costs has to take into account the high frequency of the aid delivery. There are some fixed costs but we should not worry too much about these because they will disappear once the new 'way of working' is well established. In fact, aid delivery is a transaction that will take place regularly in the

future, and these costs will be recovered easily. The increase of the fixed costs is thus a normal phenomenon. We should therefore look at all the other 'routine' costs. However, these latter do not show any positive evolution. In fact, the costs of evaluation and incoherence decrease whereas the costs of delegation increase and the costs of formulation, investment and financial control do not evolve. The main concern is thus not the fixed costs but rather the different constraints that impede the reduction of the routine costs. In fact, as said above, the evolution of the transaction costs depends strongly of the specific context. And in Mali, there are the political, institutional and technical constraints that hinder the reduction of the costs.

The technical constraint creates the fixed costs, so that our focus should be on the political and institutional constraints. The fact that some donors are still reluctant to a programme approach has many consequences. Donors' agencies for instance often maintain some specific evaluation reports or do not want to use pooling funds. They want their contribution to be visible (for political reasons). This hinders the diminution of the costs of investment, evaluation and financial control. Note also that the fact that donors do not always agree on the priorities and the policies to adopt in the sector has had some repercussions on the costs of identification (the decrease could also be stronger for those costs). Finally, the political constraint represents also the problem of harmonization of donors' procedures. More specifically, donors still use different disbursement procedures for the aid delivery and this is a heavy burden for the recipient. The costs of formulation are thus the same as with a project approach.

In addition, the institutional constraint undermines the transaction costs evolution. The donors do not really trust the institutional capacities of the recipient and consequently do not delegate, as they should in a programme approach, the administration and management tasks to the national administration. There is thus an increase in these costs since donors maintain the same management procedures than with a project. Also, the costs of investment do not change. In practice, the costs during the aid delivery are thus not decreasing with the sector approach: the donors still use their own management procedure (because of the political constraint) and do not delegate to the recipient. However, since the recipient is now more involved in the sector policy, it now faces more management costs than with the project approach (e.g. monthly meeting with donors). Another consequence of the institutional constraint is that donors do not always use financial report made by the recipient (judge too weak) and still conduct parallel control. Finally, the costs of delegation have also increased because of this constraint: the donors increase the costs to prevent the fund misuse (there were inexistent with P.A. since they fully control the funds in that case).

We should also look at the investment in harmonization. These costs, which appear with a programme approach, are not really high in Mali. In fact, the donors have not harmonized their disbursement procedures and still have specific requirements (because of the political constraint). On the other side, there is an effort of coordination between donors and the recipient's stakeholder, which generates some new costs (e.g. numerous meetings). As said above, these costs have a value added for the donors-recipients relationship and are at the core of a programme approach: new efforts are made and those will have some positive repercussions. However, the fact that the harmonization is not on the agenda hinders the reduction of some transaction costs (e.g. formulation costs). It also reflects the fact that the sector-wide approach in Mali is *hybrid*.

Consequently, is the implementation of the sector-wide approach worthwhile? We said in the first part that the change in aid modality is valuable if the increase in the investment in harmonization costs is smaller than the decrease in the transaction costs. However, in our case study, the decrease in transaction costs is not effective, because of the constraints. Also, the costs from the investment in harmonization are not very high, since the harmonization is weak (also because of the political constraint). Therefore, the potential decrease of the costs does not occur, since we have a hybrid form of a sector-wide approach. In fact, when the core principles of a programme approach, such as harmonization and ownership, are not respected, the potential of this modality is lost.

In this situation, the main questions become: is it possible to overcome the current constraints? Are the different stakeholders ready to implement a programme approach? If not, and even if everyone agrees on the principle underlying the new aid paradigm, the implementation of a programme approach is not as effective as it is supposed to be.

#### **4. CONCLUSIONS**

This last decade, the new aid paradigm that includes sector wide approach has been seen as a very promising tool to enhance aid effectiveness. It is considered as an answer to the project approach failures. The programme approach, and in particular, the sector wide approach, is a new way to think the relationship between donors and recipients. It is also supposed to reduce the transaction costs as it implies a harmonization of procedures, less duplication of efforts, the ownership of the recipients and a better prioritization.

We first wanted to understand better the concept of transaction costs, as there is no formal definition. We then define the foreign aid transaction costs and identify the major

costs. Moreover, we set up a methodology to evaluate them. In the last part of the paper, we apply this analysis framework in Mali (based mainly on a qualitative survey from 2005). We wanted to verify whether a programme approach does reduce the transaction costs, compared to a project approach.

Since we had a restricted access to the data on the indicators, we developed also a qualitative questionnaire. It is divided in two parts: the first one is devoted to the transaction costs definition and the second one to the perception of these costs evolution. We see that the predicted decrease of the transaction costs does not occur in Mali. This is because the sector-wide approach in Mali has a hybrid form: some core principles, such as harmonization and ownership, are not respected. The main causes are the political and institutional constraints. The main question is thus to know when and whether these constraints are going to disappear. If not, the potential decrease of the costs is quite doubtful.

The claim that programme approach allows a reduction of the transaction costs should thus be considered carefully. In fact, as this concept is not clear in the aid literature, it is easy to make such hypothesis. But when analysing formally the foreign aid transaction, and using the Transaction Costs Economics, one sees that this concept is complex. We cannot conclude that a particular aid modality minimizes the transaction costs without taking into account the countries contexts and the specific transaction characteristics. As we have seen in Mali, it has a huge impact on the costs evolution.

Finally, this paper shows how it is important to evaluate the foreign aid transaction costs to assess the aid effectiveness and compare aid modalities. In fact, the impact of aid evidently matters, but also the resources wasted to achieve a given impact. The transaction costs give us another part of the picture. Future researches should be dedicated to collect data on the transaction costs and measure them.

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## Appendix

Transaction costs	Costs indicators
Information and identification	- Total time devoted to this activity
	<ul style="list-style-type: none"> <li>- Staff quantity devoted to this activity</li> <li>- Total time in individuals per month, distinguishing managers from administrative staff</li> <li>- Cost (remuneration amount)</li> <li>- Staff quantity sent to recipient country</li> <li>- Number of missions and staff quantity per mission</li> <li>- Remuneration</li> </ul>
	<ul style="list-style-type: none"> <li>- Number of meetings bound to this activity</li> <li>- Costs bound to these meetings (travelling, housing, etc.)</li> <li>- Number of meetings with nationals and/or technical and financial partners → coordination meetings</li> <li>- Costs bound to these meetings (travelling, housing, etc.)</li> </ul>
Formulation	<ul style="list-style-type: none"> <li>- Total time devoted to this activity</li> <li>- Staff quantity devoted to the identification document revision</li> <li>- Total remuneration</li> <li>- Number of missions</li> </ul>
	<ul style="list-style-type: none"> <li>- Number of meetings with nationals</li> <li>- Time devoted to these meetings</li> <li>- Financial cost</li> </ul>
	<ul style="list-style-type: none"> <li>- Other financial costs (travelling, housing, etc.)</li> <li>- Costs bound to negotiation in case of disagreement about identification report</li> </ul>

Transaction costs	Costs indicators
	<ul style="list-style-type: none"> <li>- Number of conditions required by technical and financial partners</li> <li>- Number of negotiation meetings about these conditions</li> </ul>
Harmonisation	<ul style="list-style-type: none"> <li>- Time devoted to harmonisation of donor's procedures and aims</li> <li>- Number of meetings between technical and financial partners</li> <li>- Number and amount of projects financed by pooling funds</li> <li>- Number of consulting missions</li> <li>- Costs of these missions (remuneration per individual and per month and investment in car, office, etc.)</li> </ul>

*Costs during the transaction*

Investments costs (donors' expenditure)	<ul style="list-style-type: none"> <li>- Furniture investments amount</li> <li>- Number of technical experts</li> <li>- Remuneration</li> </ul>
Costs of project administration and management	<ul style="list-style-type: none"> <li>- Financial cost of project current management</li> <li>- Time devoted by experts to this task</li> <li>- Number of specific management procedures</li> <li>- Staff quantity devoted to this activity</li> </ul>
Coordination costs	<ul style="list-style-type: none"> <li>- Number (frequency) of meetings between donors and total time</li> <li>- Financial cost</li> <li>- Other costs of meetings (travelling, housing, etc.)</li> <li>- Number of meetings between donors and nationals</li> <li>- Costs of meetings</li> <li>- Experts' missions (fees, travelling, housing, etc.)</li> </ul>

*Ex post costs*

Follow-up	<ul style="list-style-type: none"><li>- Financial cost of the accountancy system</li><li>- Total time (individuals-month) devoted to this activity</li><li>- Remuneration</li><li>- Number of specific evaluation reports made by the donors</li><li>- Number of reports made by another donor in coordination with several donors</li></ul>
Financial control	<ul style="list-style-type: none"><li>- Number of specific evaluation reports made by donors</li><li>- Number of common reports for several donors</li></ul>
Extern audit	<ul style="list-style-type: none"><li>- Cost</li></ul>
Impact evaluation	<ul style="list-style-type: none"><li>- Staff quantity devoted to this task</li><li>- Remuneration</li><li>- Use of common indicators for several donors</li><li>- Number of evaluation missions</li></ul>

## Agency costs

<p>Costs linked to the appropriation of some tasks by nationals</p>	<ul style="list-style-type: none"> <li>- Staff and other resources devoted by donors to substitution expertise</li> <li>- Time devoted by national managers to negotiation and dialogue activities instead of planning and management activities</li> <li>- Individuals and months of experts devoted to a task normally achieved by the government</li> <li>- Time ratio between a task achieved by nationals and the same task achieved by a donor</li> <li>- Number and nature of conditions required by donors</li> <li>- Time devoted by civil servants to formations and seminars</li> <li>- Costs of the administrative control required by donors</li> </ul>
<p>Costs linked to coherence</p>	<ul style="list-style-type: none"> <li>- Number of projects with specific procedure (not using national procedures and systems)</li> <li>- Number of projects financed by pooling funds</li> <li>- Number of projects that do not fit in the global strategic framework</li> </ul>

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